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Financial Digest

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Analysis of Business Trends Plus Selected Financial Indicators

Bond Market Blues

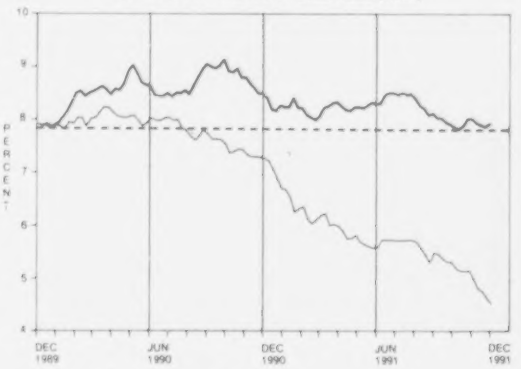
With today's ailing economy in urgent need of resuscitation, policymakers and analysts alike are scrambling to find an appropriate remedy. So far, however, the search has proven elusive. Although the Federal Reserve has already cut short-term interest rates in half over the past two years and the Federal government is running ever-larger budget deficits, neither monetary nor fiscal policy actions have been able to jump-start the economy. Nevertheless, increasing attention is being focused upon the potential benefits of tax cuts, although concerns abound that additional fiscal stimulus will unsettle the bond markets and drive long-term interest rates higher.

These concerns are exaggerated. For while cutting taxes will provide a measure of longer-term relief from the business blahs, the potential benefits of doing nothing in the hope that long-term yields will edge lower are problematic at best. Not only are there several reasons which have little to do with Washington that are keeping long-term rates stuck at current levels, but the presumed benefits arising from lower long-term yields might well skip the private sector entirely.

To be sure, longer-term borrowing costs do seem unusually high, especially when you consider the substantial tumble in short-term rates that has occurred, and the improving inflation picture. As shown in the chart, whereas three-month Treasury bill rates have dropped from better than eight percent in early 1990 to around 4½ percent today—a reflection of repeated Federal Reserve actions to drive short-term interest rates lower—this decline has not been mirrored by long-term rates. As a result, the spread between long- and short-term borrowing costs is now nearly 3½ percentage points. This is one of the largest gaps in the postwar era in absolute terms and, when scaled by the level of interest rates, the widest divergence since the early 1970s.

Long-term yields have also marched to the tune of a different drummer when compared with the rate of inflation. While eight percent, long-term Treasury bond yields appeared reasonable in late 1989, when the rate of rise in consumer prices stood not far from five percent, they seem unduly high when compared with a rate of consumer price inflation barely running at a two percent annualized clip so far this year. Indeed, the growing gap between long-term and short-term interest rates, and inflation rates, is believed to reflect almost exclusively the likelihood that Washington will soon adopt additional fiscal stimulus.

30-YEAR TREASURY BOND YIELD (THICK)
VS. 3-MONTH TREASURY BILL YIELD (THIN)



Sources: Federal Reserve; MH

The Washington Obsession

But there is more to this story. While no one can deny that the Federal budget deficit is ballooning—leapfrogging from $220 billion in fiscal 1990 to an expected $350 billion in the current fiscal year—and that the staggering river of new Treasury debt offerings needed to finance deficits of this size does pose an obstacle to lower rates, so, too, do recent actions of both corporate America and foreign investors. These have been largely overlooked as a result of the Washington obsession of the bond markets.

Take for example, corporate America, which has been actively engaged in refinancing short-term debt in the longer-term markets. While commercial and industrial loans outstanding have contracted over the past year and the volume of nonfinancial company commercial paper placements has skidded, corporate bond offerings have surged. During the first half of this year alone, long-term debt issues totaled nearly $44 billion, just about matching the full

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year 1990 total. Unfortunately, at the same time that corporate America was returning to the bond market, foreign investors were exiting. Japanese investors, for example, sharply scaled back their purchases of U.S. dollar-denominated bonds during this past summer as interest rate differentials between U.S. and Japanese securities narrowed. What is more, the transformation of Germany from a net capital exporter to a net capital importer has heightened fears of an emerging global capital shortage, hardly the ingredients for a sustained drop in long-term interest rates, almost regardless of Federal government actions.

Faulty Conventional Wisdom?

Not only is Washington's degree of responsibility for prevailing yield levels arguable, so, too, are the likely benefits to the economy even if they were lower. Although it has become axiomatic on Wall Street that today's bond yields are hobbling the recovery—by pinching such interest rate sensitive sectors as capital spending and housing—the conventional wisdom may be faulty. Throughout a good part of the 1980s, robust capital spending was undeterred by periodic bouts of bond market instability and updrafts in long-term Treasury yields. For

Short Term Paper Outstanding

(Millions of Dollars)

Time Deposits $100,000 or more Weekly Reporting Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (11/13/91)	171,062	- 1,855	- 35,942
New York City (11/13/91)	28,290	- 788	- 6,954
Commercial Paper (11/13/91)	531,436	- 857	- 22,985

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (11/13/91)	295,582	- 738	- 23,062
New York City (11/13/91)	52,966	+ 329	- 5,086

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (11/13/91)	1,010,244	+ 1,618	- 9,843
New York City (11/13/91)	168,171	+ 2,742	- 11,170

Financial Markets

	Wednesday 11/27/91	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	4.48%	- .12	- 2.74
180-Day Bills†	4.60	- .12	- 2.74
Longest Bills†	4.72	- .09	- 2.57
Recent Issues:			
5⅛s 11/30/93 (When Issued)	5.43	NA	
6⅛s 11/30/96 (When Issued)	6.53	NA	
7⅛s 11/1/01	7.41	+ .04	
8s 11/15/21	7.97	+ .06	
Municipals:			
Bond Buyer—20 Bond Index* (11/27/91)	6.78%	+ .09	- .30
Blue List Total ($ Million)	$1,739	+ $ 234	+$ 458
30-Day Visible Supply ($ Million)	$2,927	- $2,455	+$ 741
Total	$4,666	- $2,221	+$1,199
Corporates:			
Moody's Aa Composite (11/26/91)	8.79%	+ .01	- .73
30-Day Visible Supply ($ Million)	$ 990	- $ 112	+$ 440
Stocks:			
Dow-Jones Averages:			
Industrials	2,900.04	- 29.97	+340.39
Transportation	1,174.14	- 28.59	+321.14
Utilities	219.08	+ 5.26	+ 6.99
65 Stocks	1,050.66	- 9.37	+157.73
N.Y.S.E. Composite Index	208.22	- 1.21	+ 32.16
N.Y.S.E. Avg. Daily Vol. for Week (000's)	182,566	- 28,506	+30,734

*34% Taxable equivalent 10.27%

†Bond equivalent

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Wednesday 11/27/91	Week Ago
Overnight	4.88%	4.75%
1 month	4.69	4.75
3 month	4.88	4.88
6 month	4.81	4.88
1 year	4.94	5.00

FOREIGN EXCHANGE SPOT RATES

New York Opening (11/27/91)	Currency Per U.S. $	Week Ago
Belgium	33.29	33.01
Canada	1.1366	1.1362
France	5.5210	5.4745
Germany	1.6167	1.6030
Italy	1218.80	1210.80
Japan	130.15	129.75
Mexico	3074.70	3088.00
Netherlands	1.8215	1.8065
South Korea	739.93	739.65
Switzerland	1.4285	1.4225
Taiwan	25.50	25.67
U.K.*	1.7678	1.7935

*U.S. $ per U.K. pound

MH TRADE-WEIGHTED DOLLAR (11/27/91)	Change Since Week Ago	Change Since 2/27/8
(Adjusted for Inflation)	+0.1%	-11.8%

one thing, 30-year maturities are almost exclusively the preserve of the Treasury; few private entities issue such long-dated maturities. For another, the tax codes were more favorably disposed toward investment spending, and not only toward commercial real estate which was flattened by the 1986 Tax Act. Even the housing sector may not be as big a beneficiary of lower long-term rates as commonly assumed. More than one quarter of all new mortgage originations are at variable rates, the interest costs of which are tied to short- and medium-term rates, rather than long-term rates.

Indeed, postponing remedial fiscal policy actions, whether stepped up spending or cutting taxes, in an effort to appease the bond market bears allows the Wall Street tail to wag the Main Street dog. And, while the reasons for today's lofty long-term interest rates may extend well beyond the bond markets' Washington preoccupation, the tonic for the currently ailing economy does not. Putting the economy back on the growth track is going to take a lot more decisive action than sitting on the sidelines, awaiting a drop of a few, or even a few dozen basis points from Treasury bond yields.

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 11/20/91	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	268.605	- .861	+15.075
Loans to Depository Inst.	.106	+ .001	- .072
Float	.638	+ .136	+ .213
Total Reserve Bank Credit	299.791	- 2.559	+11.872
Treasury Deposits with Federal Reserve Banks	5.596	- .236	+ .221
Currency in Circulation	299.308	+ .257	+20.403
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	256.282	+ 5.761	+14.326
Member Bank Reserves:	**11/13/91**		
Total Reserves Held	52.817	+ 1.457	- 7.285
Excess (Deficiency)	.914	- .259	- .068
Net Free Reserves	.802	- .160	+ .077
Monetary Aggregates †		**‡ % Change Since 3 Months Ago***	**Year Ago**
M1 (11/11/91)	884.9	+ 9.3	+ 7.6
M2 (11/11/91)	3,406.8	+ 1.9	+ 2.5
M3 (11/11/91)	4,151.8	+ 0.2	+ 1.1
Domestic Nonfinancial Debt (2nd Q'91)	10,735.3	+ 4.6	+ 5.0

† Seasonally adjusted

* Seasonally adjusted annual rate
‡ Four-week moving average

New York Money Market

Offering Rates 11/27/91	3 Months	6 Months	1 Year
‡ U.S. Treasury Bills	4.49%	4.60%	4.72%
* Federal Agencies	4.57	4.61	4.72
* Municipal Notes–High Grade (34% Taxable Equivalent)	5.87	6.06	6.21
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market–Prime	4.81	4.76	4.95

‡ Finance Company Paper–Prime

5- 14 days	4.77%
15- 29 days	4.75
30- 59 days	4.81
60- 89 days	5.00
90-179 days	4.95
180-239 days	4.95
240-270 days	4.95

‡* Bankers' Acceptances

Dec.	4.79%
Jan.	4.90
Feb.	4.80
Mar.	4.75
Apr.	4.70
May	4.68

‡ Industrial Paper–Prime

30- 89 days	4.89%
90-120 days	4.93

†Federal Funds Effective Rate 4.00%

‡ Discount basis. *Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	3rd Q'91	$ 5,671	$ 5,612	$ 5,515
Gross National Product (1982 Dollars)*	3rd Q'91	$ 4,143	$ 4,119	$ 4,170
Percent Change, Annual Rate	3rd Q'91	+ 2.4	- 0.5	+ 1.4
Change in Consumer Prices*	Oct '91	1.2%	4.8%	7.2%
Change in MH Cost of Living Index*	Oct '91	1.2%	3.6%	3.6%
Change in Producer Prices*	Oct '91	8.4%	1.2%	14.4%
Civilian Employment (Thousands of Persons) †	Oct '91	116,967	117,165	117,733
Unemployment as % of Civilian Labor Force †	Oct '91	6.8%	6.7%	5.7%
Personal Income*	Oct '91 n	$ 4,857	$ 4,847r	$ 4,696
Leading Indicators Composite Index (1967=100) †	Sep '91	145.4	145.5	143.2
Industrial Production Index (1977=100) †	Oct '91	108.2	108.2	109.9
Net Change in Consumer Installment Credit †	Sep '91	- $ 1.54	- $ 0.85	+ $ 1.70
U.S. Merchandise Trade Balance †	Sep '91 n	- $ 6.79	- $ 6.53r	- $ 9.08
Plant and Equipment Expenditures*	4th Q'91	$ 540.9(a)	$ 539.5(a)	$ 529.0
Private Housing Starts (Thousands of Units)*	Oct '91 n	1,096	1,021r	1,026
New Construction Expenditures*	Sep '91	$ 406.5	$ 402.1	$ 437.2
Total Business Inventories †	Sep '91	$ 811.7	$ 806.6	$ 826.0
Total Business Sales †	Sep '91	$ 542.0	$ 539.6	$ 549.8

*Seasonally adjusted annual rate † Seasonally adjusted n-Newly reported figure r-Revised a-Anticipated

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